Case Study

Regulation for Expanding Rural Financial Services

Supervision and Regulation of Microfinance Industry in Ecuador-USAID / SALTO Project

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I. Introduction and Background

In October 2001, Development Alternatives, Inc. (DAI) began implementing the SALTO Project (Strengthening Access to Microfinance and Liberalization Task Order), financed by USAID/Ecuador. The project supports a central part of USAID/Ecuador's strategic objective to reduce poverty levels in Ecuador. To help achieve this objective, the SALTO Project has two components:

> (1) Support for expansion of microfinance services that directly benefit micro enterprises and the poorer segments of the population; and
>
> (2) Support for macroeconomic reforms that will contribute to sustained economic growth.

Within the first component, SALTO has worked intensively with the Superintendency of Banks to address improvements required in the policy and regulatory environment that are conducive to the development of a dynamic microfinance industry for Ecuador. The project design, in terms of linking the supervision and regulation of micro finance institutions (MFIs) and institutional strengthening, is an innovative approach to donor programs. This has enabled the project to work closely with the Superintendency and the MFIs in all issues related to creating a sustainable, efficient and effective microfinance industry in Ecuador.

II. The Microfinance Industry in Ecuador

Currently, it is estimated that there are over 1,500,000 *micro enterprises* in Ecuador, of which 40-50% are located in rural areas. It is estimated that no more than 15% of this potential clientele is currently served by formally regulated financial institutions. The rest obtain financial services in the vast informal sector which includes approximately 300 savings and loans cooperatives with a membership base of 1.3 million people, of which 60% are thought to be typical micro entrepreneurs. In addition, there are several NGOs providing credit to micro entrepreneurs through a variety of lending methodologies.

Formally regulated entities include 26 savings and loan cooperatives, two large commercial banks and one non-bank financial institution (*financiera*). Additionally, there are 12 cooperatives and one financial NGO which are expected to "graduate" into formally regulated MFIs in the near future. In all, the sector is becoming increasingly more dynamic and, quite remarkably, more competitive. As a result, outreach is steadily growing from the large urban centers to rural areas where most of the informal cooperatives operate.

The SALTO Project is currently supporting many of the largest MFIs in the country, these include: Banco Solidario, Banco del Pichincha (through their CREDI FE micro loan program), Sociedad Financiera Equatorial (SFE), Cooperativa de Ahorro y Credito de la Pequena Empresa de Cotopaxi Limitada (CACPECO), Cooperativa de Ahorro y Credito Vincentina "Manuel Esteban Godoy Ortega" (COOPMEGO), Cooperativa de Ahorro y

Credito Progreso (COOPROGRESO), Cooperativa de Ahorro y Credito "Riobamba Ltda" (RIOBAMBA) and Misión Alianza / Programa D-Miro.

Recent consolidated indicators are noted in Table 1 below:

SALTO Project
Consolidated Participating MFI Indicators [1]

Outreach	**December 2002**
Total number of active clients [2]	123,557
Increase in number of active clients (annualized from 12/01)	*37.5%*
Total number of active savings clients	149,110
Increase in number of active savings clients (annualized from 12/01)	*5.2%*
Total number of points of service	75
Average loan amount (gross portfolio / active clients)	$1,309
Average savings amount (savings / savings clients	316

The microfinance industry in Ecuador is still incipient, but there is no doubt whatsoever that it is poised to grow, and has the potential to surpass industries of Bolivia and Peru in terms of client base and total assets. The advantages it features over Bolivia are critical: Ecuador exhibits a larger market size, a higher demographic density, a more dynamic micro enterprise sector and, most importantly, a less unequal income and asset distribution. While Peru exhibits many of these same qualities, Ecuador's micro finance industry maintains an advantage because the transaction costs (costs of doing business) are lower than in Peru. Stated in a different way: in Ecuador the costs of doing "banking" are significantly lower than in Peru because of the higher quality of its economic infrastructure and of the shorter distances that separate the main urban centers from the secondary cities. Access to these cities and to small rural localities is easier in Ecuador.

For these reasons, Ecuador could become a regional leader in the development of rural financial markets. It has the potential to integrate urban and rural financial markets more rapidly, and thus create a more homogenous and larger concentration of clients. The consequence of this will be the ability of MFIs to operate at lower costs and more competitive financial spreads.

III. The Regulatory Framework

Until 2002, notwithstanding the existence of a Microfinance Division within the Superintendency, microfinance operations in Ecuador were largely unsupervised:

[1] Indicators represent consolidated numbers from all 8 MFIs, except savings which include only the 5 MFIs that are regulated and offer demand deposit accounts as of 12/02.
[2] Total portfolios for all MFIs except Banco Solidario (only micro clients are included).

- Supervisors had no knowledge of the concepts and practices of microfinance.
- Supervision techniques relied more on an auditor approach than on risk analysis. In fact, risk-based supervision practices had not been introduced.
- The division mainly supervised cooperatives while other institutions engaged in microfinance were ignored.

The main obstacle, however, was that MFIs were operating within a setting devoid of prudential norms. The banking law did not even provide the basics of a regulatory framework, such as the definition of micro loans. Given this legal void, most MFIs were adhering to prudential norms applicable to consumer lending, and critically important loan provisioning was done for past due loans only after thirty days, and not after a week or ten days which is recommended by microfinance best practices.

With the help of the SALTO Project, the Superintendency began to drafting prudential norms that applied to microfinance. These norms were eventually approved by the *Junta Bancaria* in December 2002. This pivotal event will spur the development of the industry. The main prudential norms are the following:

- A micro loan is defined as a loan that finances a micro enterprise whose source of repayments are sales from production, commerce or service activities.
- The maximum size for a micro loan is $20,000.
- Loan provisioning is mandatory after five days of arrears.
- The MFIs have the liberty to establish the loan size above which guarantees would be required. For loans below this amount, all that is needed is a personal guarantor or a document signed by the borrower stating the personal assets that can be seized in case of loan default.
- Financial institutions can voluntarily provision above specific provision requirements set by the Superintendency.
- Loans that are 90 days past due must be provisioned at 100% and written off in no later than 180 days past due.

One of the most important steps taken by the Superintendency was the decision to align loan provisioning norms for both micro loans and consumer lending. Under this regime, loan provisioning for consumer loans must follow the very strict standards applicable to micro loans. The purpose of this ground breaking decision, which to our knowledge has not been embraced by any other Latin American country, is explained by three reasons.

The first is to avoid market distortions. Before the new regulation to align the two norms was enacted, financial institutions were succumbing to the temptation of classifying their loans as consumer credit, taking advantage of markedly less strict provisioning requirements.

The second reason is that norms should take into account evolving market trends. The broad perception is that MFIs were gradually penetrating the typical consumer lending niche. In fact, the opposite is also true. Consumer lenders have begun targeting micro entrepreneurs. In Chile, for example, some financial institutions are targeting the larger micro market segment with technologies that do not differ significantly from consumer lending.

The third reason is that in Ecuador consumer lending has seen explosive growth in the last two years. It is imperative that this continued growth be supported by prudence and safety for depositors. We are well aware of the crises that plagued other countries and we do not want this to be repeated in Ecuador. For this reason, loan provisioning norms for consumer lending must be as strict as those applied to microfinance. In a country with fresh memories of a banking collapse, this is a principle that we intend not to violate.

The following Table 2 illustrates the recently enacted norms for classifying consumer and micro loans:

Consumer and Micro Loan Classification

Loan Category	**Days in Arrears**	
	More than	**Up to**
Performing		Five
OAEM[3]	Five	Thirty
Substandard	Thirty	Sixty
Doubtful	Sixty	Ninety
Loss	Ninety	

The regulatory framework that has been adopted by Ecuador captures some aspects of the Bolivian and Peruvian legislation but differs in one fundamental point: it is not a specialized law and thus, is not tailored to the risk profile of clients not traditionally served by commercial banks (e.g. micro entrepreneurs). As such, Ecuador is unlikely to adopt any non-bank financial intermediary laws that are characteristic of countries in the region (e.g.– the *fondos financieros privados* (Bolivia) and the *cajas municipales, cajas rurales and edpymes* (Peru)). In Ecuador, the microfinance industry will be able to grow under the umbrella of a banking law that is applied to all types of institutions and within this law, there is still opportunity for differential, namely, a lower stated minimum capital requirement for *financieras* than for commercial banks. The Sociedad Financiera Ecuatorial (SFE), one of the stellar performers in the microfinance field has already taken advantage of this differentiation within the law. There is no reason why other potential entrants cannot follow this example.

Not following the path of Bolivia and Peru makes good sense. In Ecuador, markets are not as segmented or fragmented as in those other Andean countries. The development of a microfinance industry stands a better chance when larger financial institutions are actively engaged in the field, and notably larger commercial banks are gradually becoming more involved in the sector. Equally significant is the fact that the SFE is reportedly willing to apply for a bank license in two years.

[3] Other Assets Especially Mentioned

IV. Supervision

Part of the endeavor to develop prudential norms is the necessary training and technical assistance being provided to supervisors. Manuals have been drafted; fields tested and are in use by the regulators who are tasked with supervising the regulated institutions currently offering micro and consumer lending products to the public. Supervisors have been trained to understand the differences between microfinance, consumer lending and other financial products within the framework of regulated institutions. Pilot tests were conducted successfully in savings and loan cooperatives and MFIs.

Progress in supervision is measured by two events of major impact. The first has been the identification and intensive training – in Ecuador and overseas – of a cadre of future leaders. This cadre is made up primarily of young professionals who have both the capacity to train other colleagues, and also act as advocates of the virtues of microfinance within the Superintendency. In this regard, the impact has been impressive, as other supervisors working in allegedly more prestigious areas, such as the commercial bank division, have sought to enlist the participation of microfinance supervisors in their own planning and training sessions.

The second event has been the introduction of risk-based supervision techniques. Supervisors, led by the new leaders, are adopting an analytical approach to their tasks, concentrating on the identification and evaluation of critical risks factors – corporate governance, credit, market, and liquidity. In this process, they are gradually disposing of outdated auditing approaches.

V. Credit Bureau Regulation

Learning from the experience of their neighbors in Bolivia and Peru through study tours and reciprocal visits, the Superintendency also requested assistance from SALTO in developing policies to govern the installation of private credit bureaus in the country. In particular, the new policies allow for the equal exchange of information between all financial intermediaries – regulated and non-regulated. This information exchange is key in mitigating the development of over indebtedness which has plagued many countries whose client credit systems do not allow access to ***all*** financial intermediaries. SALTO has worked intensively with the Superintendency during the past nine months on this activity. In December 2002, the Superintendency issued the formal norms that will govern the licensing and operation of private credit bureaus in Ecuador. SALTO is now assisting the Superintendency in marketing the opportunity to both international and domestic investors, with the goal of attracting at least one private group to establish a credit bureau by the end of 2003.

VI. Challenges

While progress in just one year has been impressive, much remains to be done to propel the development of microfinance in Ecuador.

First, institutional and policy impediments must be removed. So-called rules of the game can still be changed at will while the legal system is inefficient and unpredictable, and red tape can be a nightmare. On the policy side, there is a ceiling on loan interest rates. It must be underscored that all these, are not impairing obstacles, as evidenced by the decision of the SFE to enter the market, but they do entail high costs of doing business.

Second, the Superintendency is in need of institutional reform, not unlike the reforms that were successfully launched in Bolivia and Peru. The institution must be streamlined, and be made y autonomous, and free from the undue political interference that has greatly constrained its efficiency and demoralized the most competent staff.

Third, and because of its social and economic importance in rural areas, the cooperative sector should not be abandoned. During the banking crisis, the cooperatives weathered the storm bravely and saw the increase in their deposit base. Put simply, people put their money in institutions that they trusted and historically the acceptable financial performance of cooperatives in Ecuador during so many years is proof of that. Because cooperatives naturally function in proximity to the rural and urban poor, and because they have $160 million in savings from their memberships, all this must be monitored carefully and protected, especially now that they operate within a much keener competitive environment. Since late 2002, the SALTO project has coordinated all activities related to the cooperatives with the USAID/WOCCU project. This collaboration will ensure that program goals and institutional strengthening activities will support the cooperatives in a complementary manner.

Fourth, careful attention should be given to the entry requirements of cooperatives into the formal sector. We must evaluate whether the $200,000 minimum requirement is appropriate. We do not want to discourage entry but, at the same time, we should not encourage entry of institutions with very low capital bases that will hinder capacity to introduce innovative products and operate with acceptable efficiency standards, let alone to fend off competition. If, under this regime, 50 new cooperatives will be regulated in the next year, as expected, this will present additional challenges to the Superintendency that must be addressed promptly.

Fifth, with regard to the Credit Bureau activity, the next challenge, and the critical one, will be the successful attraction of private investors to establish one or more credit bureaus in Ecuador during the balance of 2003. This will enable the development of a healthy market-oriented micro finance industry in Ecuador that will be able to serve both urban and rural clients.